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Policy Brief

Productivity puzzle? Financialization, inequality, investment in the UK

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Abstract: According to econometric estimations using firm balance sheets of the publicly listed companies in the UK, in large non-financial corporations (NFCs), investment rate would have been 16% higher without the rise in financial payments, and 41% higher without the increasing financial incomes, and in the small NFCs, investment would have been 35% higher without the rise in financial incomes.

Keywords: Financialization, Investment, Non-financial sector, Firm data, UK, productivity puzzle

JEL codes: C23, D22, G31

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Productivity puzzle? Financialization, inequality, investment

Productivity in Britain is lower than other developed countries, and the Great Recession has made this dismal performance even worse. This is not at all a puzzle given the investment and growth pattern in Britain. Among developed countries, Britain also has one of the lowest private investment rates as a ratio to GDP. At the core of this development lies the missing link between profits and investment. Rising inequality and financialization have been the main reasons behind this missing link and hence the major brakes on investment, growth, and productivity.

Productivity is defined as output per employee and has two components: one is simply related to demand, as actual output is demand driven. The second component is about potential productivity, which is determined by technological progress, which is in turn affected by both investment and wage costs.

Private investment responds to demand and public infrastructure and not just to profitability. Britain's reliance on low wages not only leads to lower demand and affects investment through the demand channel, but also makes firms reluctant to invest due to a tendency to exploit low labour costs.

Despite increasing profits, private investment has been weak in Britain since the 1980s, as firms directed their profits to financial speculation. According to our recent research at the Greenwich Political Economy Research Centre on the investment behaviour of non-financial corporations (NFCs) in Britain, not only high dividend payments but also increasing financial revenues of firms due to their surging financial activities crowd out private investment in physical machinery and equipment (Tori and Onaran, [2015](#); [2017](#)). Perversely, financial activities do not provide more funds for productive activity, in particular in the case of large companies as firms direct their profits to financial speculation.

Figure 1 shows the ratio of investment (addition to fixed assets) to operating income; i.e. the rate of reinvestment, and the stock of financial assets as a ratio to fixed assets. There has been a clear decline of the operating income devoted to the enlargement of NFCs' core activities from 80-90% in the 1980s to 40-50% in the last decade. Despite the partial recovery of investments since 1992, the rate of reinvestment continued to decline. In sharp contrast, the stock of financial assets increased substantially, reaching 90% as a ratio to fixed capital in the late 1980s, and a level more than three times the fixed assets before the crisis in 2008. The financial crisis in 2008 has led to only a slight fall in the value of the financial assets.

In the UK (figure 2), the rate of accumulation (investment/capital stock) has remained stagnant around an average of 25% for the whole period, and the reinvested profits declined. In sharp contrast, the stock of financial assets increased substantially, reaching 3.6 times higher than fixed assets in 2015. This substantial involvement in the accumulation of financial assets resulted in increasing non-operating income for the NFCs until the 2007-2008 crisis. Financial payments of the NFCs in the form of interests on debt and dividends paid to the shareholders also increased substantially since the mid-1990s, partially recovering from a decline during the crisis period.

According to our econometric estimations using firm balance sheets of the publicly listed companies in the UK, in large NFCs, investment rate would have been 16% higher without the rise in interest and dividend payments, and 41% higher without the increasing

financial incomes, and in the small NFCs, investment would have been 35% higher without the rise in financial incomes (Tori and Onaran, 2017).

The physical accumulation in manufacturing sector suffered even more experiencing a finance-led deindustrialisation. In particular, for the pre-crisis period in manufacturing we find that the adverse effects of financial payments and financial incomes almost entirely offset the positive impacts due to increasing sales and retained profits (Tori and Onaran, 2015).

Financialization and its effect on corporate strategies have also had detrimental effects on the bargaining power of labour and inequality ([Guschanski and Onaran, 2016](#)). On the one hand, the orientation towards shareholder value increased the dominance of shareholders' demands over workers' demands. On the other hand, increased domestic and global financial investment opportunities increased the fall-back options of non-financial firms both in terms of geographic location as well as financial assets, putting pressure on irreversible, domestic real investment in physical machinery and capital.

Financialization and increased fall back options of capital, in particular with respect to tax competition between different jurisdictions, has also had effects on the composition of public spending and taxation ([Onaran and Boesch, 2014](#)), which in turn has further contributed to the decline in the bargaining power of labour as well as public infrastructure and productivity.

These developments went along with further institutional and structural changes that led to a significant fall in trade union density and collective bargaining coverage. As a result, in the last three and a half decades, inequality has increased substantially and the share of national income that goes to wages has fallen dramatically. The share of wages in UK GDP fell from its peak of 76.2% in 1975 to 67.7% in 2007, and after the Great Recession further to 65.8% in 2015.

Wage stagnation has fuelled increasing profits as a share of GDP, but this has led to bleak prospects in terms of demand, and this in turn discourages investment despite high profitability. While this is a puzzle from a neoclassical point of view, it is not unexpected for Post-Keynesian/Kaleckian economics, which highlight the dual role of wages as both a cost item and source of demand. Our findings show that a lower share of wages in national income leads to a lower GDP in Britain as well as most large countries ([Onaran and Obst, 2016](#); [Onaran and Galanis, 2014](#); Obst, Onaran, Nikolaidi, 2017).

Hence the demand regime is "wage-led". On the one hand, a pro-capital redistribution of income leads to lower domestic consumption demand. On the other hand, the stimulus to private investment due to higher profits remains weak (or even absent) and at the same time private investment responds very negatively to the fall in demand. Our results show that despite increasing profit share in GDP, private investment decreased in Britain due to the substantially negative impact of the fall in the wage share on demand ([Onaran and Obst, 2016](#); Obst, Onaran, Nikolaidi, 2017). Firms directing their profits to financial speculation in the absence of a healthy growth in demand is as much a result of this process as it is a contributor to the lack of demand.

The much celebrated impact of wage stagnation on external demand, i.e. higher net exports, is rather weak in Britain, and the impact is diminished substantially when all countries implement the same international competitiveness policies based on labour market flexibility and a race to the bottom on wages ([Onaran and Galanis, 2014](#); [Onaran and Obst, 2015](#)). This leaves Britain with the net negative impact of rising inequality on domestic demand. This explains why Britain's export performance is so weak despite

falling labour costs: international competitiveness is more about productivity than labour costs, particularly in a world in which a race to the bottom in labour costs has been normalised.

In the aftermath of the Great Recession, the lack of a full recovery in wage income continues to be a drag on household confidence and demand, which in turn discourages business investment in the absence of a healthy growth in domestic demand. In the past, the UK relied on household debt to maintain consumption levels in the absence of growth in wages. After the crisis, recovery is still based on the same shaky grounds as it is driven by a massive increase in private household debt and will remain fragile to any increase in interest rates in the future. The rise in inequality and stagnation in wages has been one of the fundamental flaws in the neoliberal economic model, which has been at the root of the Great Recession, and we are far from correcting this imbalance.

Overall, the mixture of financialization and rising inequality has created an increasingly more fragile mode of production with volatile and stagnant demand and investment. In the absence of strong investment performance and stagnant demand, it is no wonder that Britain is in a phase of low productivity and low potential growth.

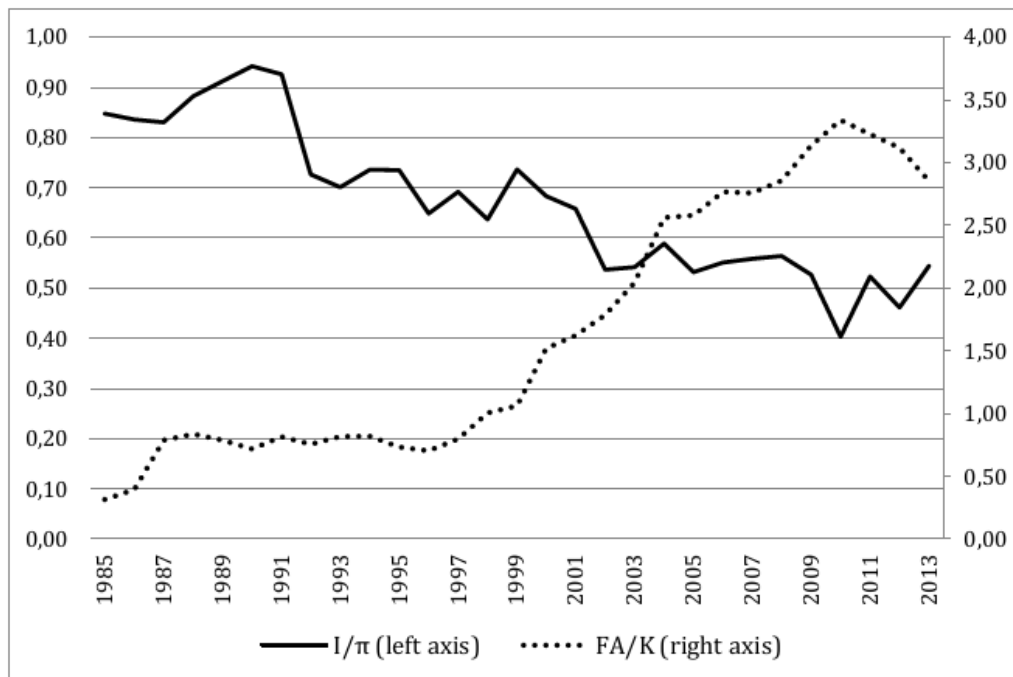
A process of de-financialization of the non-financial sector is a pre-condition for a stable and vigorous investment performance. This would require an extended regulation of companies' non-operating financial activities along with financial regulation.

Managers' short termist behaviour and decisions exclusively aimed at maximizing dividends distributed to the shareholders should be disincentivized. What is needed is the provision of an institutional setting for the NFCs that encourage management orientation towards long term growth and, more generally, 'stakeholder value'. This should be addressed in particular in the case of larger corporations.

The focus of corporate governance should be on the destination of the funds. The corporation today is an institution composed of different layers of productive and non-operating activities. Policies should aim at favouring a productive destination of NFCs' internal funds, e.g. higher rate of taxation on profits which are not invested.

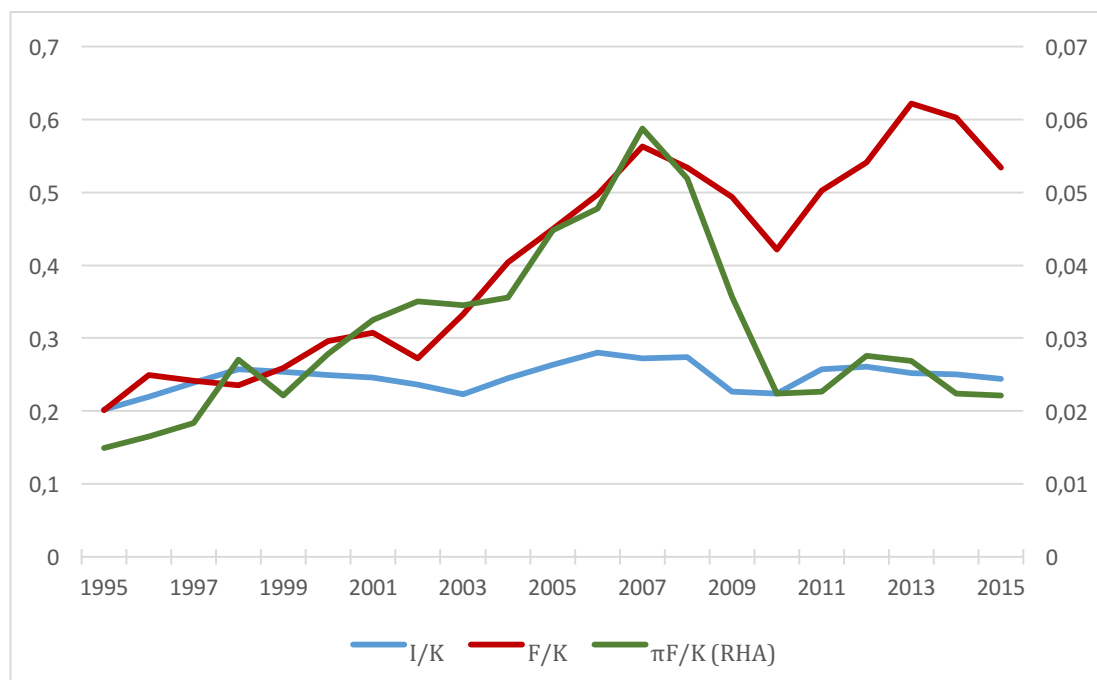
The empirical evidence regarding the vicious circle of financialization - rising inequality, sluggish accumulation and productivity - hints at the need for a coordinated policy mix of alternative progressive labour market policies targeting the top, middle, and bottom of the wage distribution to reverse inequality embedded in a broader macroeconomic and industrial policy, financial regulation and corporate governance framework (Onaran, 2015). Only then will investment and productivity follow.

Figure 1. Investment/Operating income (I/π), and financial assets/fixed assets (FA/K) in NFCs, the UK



Source: Tori and Onaran (2015) based on Worldscope data

Figure 2 Investment/Fixed Assets (I/K), total financial payments/fixed assets (F/K), and total financial profits/fixed assets (π_F/K , RHA), NFCs in the UK.



Source: Tori and Onaran (2017) based on Worldscope data

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